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D-2010-087

September 27, 2010

Inspector General

United States

Department of Defense



Weaknesses in Oversight of Naval Sea Systems Command Ship Maintenance Contract in Southwest Asia

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Acronyms and Abbreviations

CLIN	Contract Line Item Number
COR	Contracting Officer's Representative
DCAA	Defense Contract Audit Agency
DFARS	Defense Federal Acquisition Regulation Supplement
FAR	Federal Acquisition Regulation
FMR	Financial Management Regulation
FMSNA	Fincantieri Marine Systems North America
GAO	Government Accountability Office
IDIQ	Indefinite-Delivery, Indefinite-Quantity
IFM	Isotta Fraschini Motori
IG	Inspector General
MARMC	Mid-Atlantic Regional Maintenance Center
MCM	Mine Countermeasures
NAVSEA	Naval Sea Systems Command
O&M	Operations and Maintenance
QASP	Quality Assurance Surveillance Plan
U.S.C.	United States Code



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
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ARLINGTON, VIRGINIA 22202-4704

September 27, 2010

MEMORANDUM FOR NAVAL INSPECTOR GENERAL

SUBJECT: Weaknesses in Oversight of Naval Sea Systems Command Ship
Maintenance Contract in Southwest Asia (Report No. D-2010-087)

We are providing this report for review and comment. In October 2006, the Navy awarded a contract to Fincantieri Marine Systems North America for ship maintenance services to be performed in Bahrain, Japan, and Texas. Navy contracting officials did not properly manage this contract, valued at \$40 million, in accordance with Federal and DOD regulations.

DOD Directive 7650.3 requires that recommendations be resolved promptly. The Naval Sea Systems Command Executive Director for Contracts did not respond to the draft report. Therefore, we request that the Naval Sea Systems Command Executive Director for Contracts provide comments on the final report by October 27, 2010.

If possible, send a .pdf file containing your comments to audacm@dodig.mil. Copies of your comments must have the actual signature of the authorizing official for your organization. We are unable to accept the /Signed/ symbol in place of the actual signature. If you arrange to send classified comments electronically, you must send them over the SECRET Internet Protocol Router Network (SIPRNET).

We appreciate the courtesies extended to the staff. Please direct questions to me at (703) 604-9071 (DSN 664-9071).

Bruce A. Burton
Deputy Assistant Inspector General
Acquisition and Contract Management

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Results in Brief: Weaknesses in Oversight of Naval Sea Systems Command Ship Maintenance Contract in Southwest Asia

What We Did

This is the third in a series of reports on Army and Navy ship maintenance contracts for Southwest Asia. For this report, we reviewed a Naval Sea Systems Command (NAVSEA) contract, valued at \$40 million, for ship maintenance in Bahrain, Japan, and Texas. We determined that NAVSEA contracting officials did not properly manage or administer the contract in accordance with Federal and DOD regulations.

What We Found

NAVSEA did not correctly structure the cost-type contract or perform adequate quality assurance. Specifically the contracting officer:

- ~~(FOUO)~~ Structured the contract line items for engine repair parts as a prohibited cost-plus-a-percentage-of-cost system of contracting because he did not establish a set fee amount under individual task orders, potentially allowing Fincantieri Marine Systems North America (FMSNA) to inappropriately earn [REDACTED] in fees for the first 3 years of the contract.
- Did not properly manage the contract because he “banked” \$20.3 million when he issued task orders to obligate funds before specific requirements were identified. Eventually, the contracting officer’s representative used \$19.2 million for defined requirements. The remaining \$1.1 million, if expended, could result in potential bona fide needs rule violations.
- ~~(FOUO)~~ Did not provide sufficient quality assurance for six task orders in Bahrain because he was unaware of his responsibilities to provide surveillance. As a result, there is no assurance the Navy received [REDACTED] in contracted for supplies and services.

Since October 2008, FMSNA has not provided certified cost or pricing data to negotiate costs on spare parts transferred from its affiliate. The contracting officer should have elevated the issue to more senior officials. The Navy could be overcharged if the required cost information is not obtained.

What We Recommend

The NAVSEA Executive Director for Contracts:

- issue task orders that clearly describe all services to be performed and supplies to be delivered, and negotiate fair and reasonable prices for parts on all future orders;
- perform a review and initiate appropriate administrative action on the contracting officer for allowing a prohibited cost-plus-a-percentage-of-cost system of contracting;
- verify and deobligate the dollar value of invalid unliquidated obligations on contract;
- develop a quality assurance surveillance plan for the contract and assign a contracting officer’s representative in theatre to perform quality assurance in accordance with the quality assurance surveillance plan; and
- assist the contracting officer in obtaining certified cost and pricing data for the negotiation of fair and reasonable prices on the interdivisional transferred parts.

Management Comments and Our Response

The NAVSEA Executive Director for Contracts did not comment on the draft report issued on July 21, 2010. We request the NAVSEA Executive Director for Contracts comment on the recommendations by October 27, 2010. Please see the recommendations table on the back of this page.

Recommendations Table

Management	Recommendations Requiring Comment
Naval Sea Systems Command Executive Director for Contracts	A.1, A.2, B.1, B.2, B.3, C.1, C.2, C.3, D.1, D.2

Please provide comments by October 27, 2010.

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Introduction

Objectives

This is the third in a series of reports on the Army and Navy ship maintenance contracts for Southwest Asia. The overall objective was to determine whether contracts providing ship repairs and maintenance to Army operations in Kuwait and Navy operations in Bahrain and United Arab Emirates were properly managed and administered. This report includes information on the contract we reviewed in U.S. Naval Sea Systems Command (NAVSEA). We reviewed the appropriateness of the type and structure of the contract and the adequacy of quality assurance for NAVSEA indefinite-delivery, indefinite-quantity (IDIQ) contract N00024-07-D-4002 for ship maintenance in Bahrain, Japan, and Texas. DOD Inspector General (IG) Reports D-2010-005 and D-2010-064 address the audit objective for Army operations in Kuwait and Navy operations in Bahrain and include findings on the Fleet and Industrial Supply Center, Sigonella, Detachment Bahrain; and U.S. Army, Mission and Installation Contracting Command. Additional findings for the Fleet and Industrial Supply Center, Sigonella, Detachments Bahrain and Dubai, will be addressed in the fourth and last report in the series. See Appendix A for a discussion of our scope and methodology. See Appendices B and C for other matters of interest.

We performed this audit pursuant to Public Law 110-417, The National Defense Authorization Act for Fiscal Year 2009, section 852, “Comprehensive Audit of Spare Parts Purchases and Depot Overhaul and Maintenance of Equipment for Operations in Iraq and Afghanistan.” Section 852 requires “thorough audits to identify potential waste, fraud, and abuse in the performance of Department of Defense contracts, subcontracts, and task and delivery orders for (A) depot overhaul and maintenance of equipment for the military in Iraq and Afghanistan; and (B) spare parts for military equipment used in Iraq and Afghanistan.”

According to GlobalSecurity.org, Bahrain and the United States signed an agreement in October 1991 granting U.S. forces access to Bahraini facilities and ensuring the right to preposition material for future crises. Also according to information at this site, in 1996 two *Avenger*-class mine countermeasures (MCM) ships were forward-deployed to the Gulf enhancing the U.S. naval presence and ability to preserve the security of regional sea lines of communication to enforce United Nations sanctions in Iraq.

Background

The NAVSEA contracting office and program management office for IDIQ contract N00024-07-D-4002 are located at the Navy Yard in Washington, D.C. NAVSEA’s mission is to “develop, deliver, and maintain ships and systems on time [and] on cost for the United States Navy.” NAVSEA’s goals include “building a . . . future Fleet” and “sustain[ing] today’s Fleet efficiently and effectively.”

Mine Countermeasures Ships

MCM ships are designed to clear mines from vital waterways. *Avenger*-class ships, a type of MCM ship, are designed as mine hunter-killers capable of finding, classifying, and destroying moored and bottom mines. The last three MCM ships were purchased in 1990, bringing the total to 14 fully deployable, oceangoing, *Avenger*-class ships. These ships use sonar and video systems, cable cutters, and a mine detonating device that can be released and detonated by remote control to destroy mines. They are also capable of conventional sweeping measures.

NAVSEA Contract N00024-07-D-4002

IDIQ contract N00024-07-D-4002 was issued to Fincantieri Marine Systems North America (FMSNA) on October 27, 2006, as a sole-source letter contract with a total not-to-exceed amount of \$53,553,659. The contracting officer later definitized the contract through modification PZ0007 on July 11, 2007, and set the ceiling in the amount of \$40,333,530. The contract was issued for the performance of warehouse management, preventative maintenance support, engineering, and planned product improvement program services to be performed in Bahrain, Japan, and Texas and is structured using cost-reimbursable and fixed-price contract line item numbers (CLINs).

IDIQ Contracts

Federal Acquisition Regulation (FAR) Subpart 16.504, “Indefinite-Quantity Contracts,” prescribes the use of indefinite-quantity contracts and states that

an indefinite-quantity contract provides for an indefinite quantity, within stated limits, of supplies or services during a fixed period. The Government places orders for individual requirements. Quantity limits may be stated as number of units or as dollar values.

Contracting officers may use an indefinite-quantity contract when the Government cannot predetermine, above a specified minimum, the precise quantities of supplies or services that the Government will require during the contract period, and it is inadvisable for the Government to commit itself for more than a minimum quantity.

FAR Subpart 16.505, “Ordering,” prescribes the procedures for ordering against an IDIQ contract and states that the contracting officer cannot synopses orders under an indefinite-delivery contract but must “clearly describe all services to be performed or supplies to be delivered so the full cost or price for the performance of the work can be established when the order is placed. Orders will be within the scope, issued within the period of performance, and be within the maximum value of the contract.”

Review of Internal Controls

DOD Instruction 5010.40, “Managers’ Internal Control Program (MICP) Procedures,” July 29, 2010, requires DOD organizations to implement a comprehensive system of internal controls that provides reasonable assurance that programs are operating as intended and to evaluate the effectiveness of the controls. We identified internal control

weaknesses for NAVSEA. NAVSEA did not have internal controls for structuring contract line items for engine repair parts, obligating funding, and contract quality assurance. Implementing the recommendations in Findings A, B, and C will improve NAVSEA's internal controls. We will provide a copy of the report to the senior official responsible for internal controls in the Department of the Navy.

Finding A. Prohibited Cost-Plus-a-Percentage-of-Cost Structure Used for Engine Repair Parts

~~(FOUO)~~ The NAVSEA contracting officer allowed FMSNA to collect a profit on task orders issued under IDIQ contract N00024-07-D-4002 using the prohibited cost-plus-a-percentage-of-cost system of contracting on cost-reimbursable contract line items for engine repair parts. Specifically, the contracting officer allowed the contractor to collect a [REDACTED] fee on engine repair parts worth approximately [REDACTED] resulting in a fee of about [REDACTED]. In addition, the contractor can potentially earn a fee of about [REDACTED] for the first 3 years of the contract if this practice continues. This occurred because the contracting officer incorrectly issued task orders under the contract. The contracting officer also did not establish a set fee amount under individual task orders for the engine repair part contract line item, potentially allowing the contractor to maximize its profit by purchasing the most expensive parts. To ensure that the prohibited cost-plus-a-percentage-of-cost system of contracting is no longer used, the NAVSEA contracting officials should:

- correctly issue task orders under IDIQ contract N00024-07-D-4002,
- establish a fixed-fee amount when issuing task orders for repair parts, and
- negotiate fair and reasonable prices for repair parts on all future orders.

Prohibition on the Use of Cost-Plus-a-Percentage-of-Cost Contract Types

Section 2306, title 10, United States Code (10 U.S.C. 2306) and Federal Acquisition Regulation (FAR) 16.102 (c), “Policies,” prohibit the use of a cost-plus-a-percentage-of-cost system of contracting. A Comptroller General decision, “Marketing Consultants International Limited,” B-183705, 55 Comp. Gen. 554, December 10, 1975, citing the Supreme Court in “Muschany vs. United States,” 324 U.S. 49, 61-62 (1945), states that the underlying intent of Congress when prohibiting cost-plus-a-percentage-of-cost contracts was to protect the Government against exploitation when using such a system of contracting. According to the Comptroller General decision, the danger in using a cost-plus-a-percentage-of-cost contract is the incentive to the contractor to pay liberally for cost-reimbursable items because a higher cost means a higher fee to the contractor. Additionally, the Comptroller General decision states that Congress indicated it did not care how a contractor computed the fee or profit as long as the contractor fixed that fee or profit at the time when the Government became bound to pay it by the Government’s acceptance of the contractor’s bid.

Allowable Cost-Reimbursement Contract Types

FAR Subpart 16.301-1, “Description,” states that the types of cost-reimbursement contracts are cost contracts, cost-sharing contracts, cost-plus-incentive-fee contracts, cost-plus-award-fee contracts, and cost-plus-fixed-fee contracts. In cost contracts, the contractor does not receive a fee for work performed. In a cost-sharing contract, the contractor does not receive a fee and is reimbursed only for an agreed-upon portion of costs incurred. Cost-plus-incentive-fee contracts provide for a negotiated fee that is adjusted at a later time based upon the actual allowable costs compared to the target costs. A cost-plus-award-fee contract provides for a fee that consists of a base amount, which is fixed at the inception of the contract, and an award amount that is sufficient to motivate excellent performance. Finally, a cost-plus-fixed-fee contract provides for the payment of a negotiated fixed fee.

Government Accountability Office Four-Part Test

The NAVSEA IDIQ contract N00024-07-D-4002 met all four of the prohibited cost-plus-a-percentage-of-cost guidelines outlined in the Comptroller General decision B-183705. In this decision, the Government Accountability Office (GAO) states that the guidelines for determining whether a contract arrangement constitutes a prohibited cost-plus-a-percentage-of-cost contract are whether:

1. payment for profit is based on a predetermined percentage rate,
2. the predetermined percentage rate is applied to actual performance costs,
3. contractor entitlement is uncertain at the time of contracting, and
4. contractor entitlement increases commensurately with increased performance costs.

Predetermined Percentage Rate

~~(FOUO)~~ The contracting officer established a predetermined percentage rate of [REDACTED] as the fee for certain cost-reimbursable subCLINs,¹ specifically for selected repair parts. Although the contract states that the fee is “not-to-exceed” [REDACTED] the contracting officer consistently applied the [REDACTED] rate to all actual costs for those subCLINs.² The contract meets the first part of the GAO four-part test for determining whether the contract contains prohibited cost-plus-a-percentage-of-cost CLINs.

Percentage Rate Applied to Actual Performance Costs

~~(FOUO)~~ The contracting officer applied the predetermined percentage rate [REDACTED] to the actual performance costs of the contractor. As shown in Table 1, the fee calculated for each task order equals exactly [REDACTED] of the cost of repair parts, including added fees for material handling and general and administrative items. The contract meets the second test in the GAO four-part test for determining whether a contract contains prohibited cost-plus-a-percentage-of-cost CLINs.

¹ The subCLINs are 000903, 001903, 002703, and 003503.

² The fees for cost of spare parts are shown in Table 1.

~~(FOUO)~~ Table 1. Actual Fee Authorized to Contractor

Task Order	TO 0002	TO 0006	TO 0007	TO 0008	TO 0010	Total
Cost of Parts	\$7,000	\$12,021	\$693,175	\$584,467	\$541,810	\$1,838,473
Material Handling						
G& A						
Subtotal						
Fee						
Total	\$10,343	\$17,762	\$1,024,242	\$863,613	\$800,583	\$2,716,543

TO

Task Order

G&A

General and Administrative

Uncertain Contractor Entitlement

~~(FOUO)~~ The contractor's entitlement was uncertain at the time of contract definitization because there was no negotiated dollar amount associated with the cost-reimbursable subCLINs. The contract started as a letter contract, which requires definitization to negotiate and agree on a contract price. However, modification PZ0007, the definitization modification to the contract, did not include a negotiated fee. Modification PZ0007 included information on the cost-reimbursable subCLINs but did not include a dollar amount associated with those subCLINs, for example, a certain entitlement. Modification PZ0007 to the contract indicated that the amount for subCLINs 000903, 001903, 002703, and 003503 included the cost of selected repair parts plus a fee not to exceed [REDACTED]. Further, the contracting officer did not correctly issue definitized task orders under IDIQ contract N00024-07-D-4002 (see Finding B). The task orders the contracting officer issued containing CLINs 0009, 0019, 0027, and 0035 did not establish a set profit for the subCLINs. Instead the fee was calculated based on the actual cost of parts the contractor requested reimbursements for after the work was completed (see Table 1). The contract, therefore, meets the third part of the GAO four-part test for determining whether a contract is a cost-plus-a-percentage-of-cost type contract.

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Contractor Entitlement Increases as Performance Costs Increase

~~(FOUO)~~ The contractor's fee for this contract increased commensurately with increased costs of repair parts. For example, in task order 0002, when the cost for repair parts was \$6,999.54, the fee to the contractor was [REDACTED]. When the cost of repair parts was much higher, as in task order 0007

The contractor's fee for this contract increased commensurately with increased costs of repair parts.

(\$693,175.27), the fee to the contractor is also much higher [REDACTED]. The contract meets the fourth part of the GAO four-part test for determining whether a contract has prohibited cost-plus-a-percentage-of-cost CLINs. See Table 1 on page 6.

Inappropriate Potential Contractor Fee

~~(FOUO)~~ We calculated a potential fee of approximately [REDACTED] based on the amount obligated to the cost-reimbursable CLINs that included the repair parts subCLINs. However, we could not determine which subCLINs the contracting officer obligated money to because the contracting officer obligated the money at the CLIN level and did not sufficiently define the requirements to the subCLIN level. Therefore, the [REDACTED] is the potential fee that could be earned based on applying the [REDACTED] profit rate because we could not determine whether the contracting officer obligated funds toward subCLINs that allow fees. The contracting officer believed that the only potential fee the contractor could earn is on the interdivisional transferred parts valued at [REDACTED] from FMSNA's affiliate IFM (see Finding D). The [REDACTED] includes the fee that has already been paid to the contractor as well as the fee that could be paid based on applying the [REDACTED] fee to the money obligated to the cost-reimbursable CLINs. Because the contracting officer issued the task orders to bank funds (see Finding B) and consistently applied the [REDACTED] fee rate to actual costs the maximum fee FMSNA could earn is approximately [REDACTED] (see Table 2).

~~(FOUO)~~ Table 2. Potential Fee Contractor Could Earn

	FY 2007	FY 2008	FY 2009	Total
Total Funds Obligated to Cost Reimbursable CLINs				
Subtotal of Obligated Funds Without Fee				
Fee				

Conclusion

~~(FOUO)~~ The danger in using a cost-plus-a-percentage-of-cost contract is the incentive to the contractor to pay liberally for cost-reimbursable items because a higher cost means a higher fee to the contractor. We determined that the contractor's fee increased as costs increased, illustrating the incentive to the contractor to purchase higher cost repair parts. The contracting officer obligated a total of [REDACTED] to cost-reimbursement CLINs 0009, 0019, and 0027 through task orders and task order modifications. The potential fee for the total amount obligated to the cost-reimbursement CLINs is [REDACTED] (see Table 2). Revising the contract should reduce costs. The NAVSEA Executive Director for Contracts should review the contracting officer's actions for allowing a prohibited cost-plus-a-percentage-of-cost system of contracting.

Recommendations

A. We recommend that the Naval Sea Systems Command Executive Director for Contracts:

1. Direct the contracting officer to:
 - a. Issue task orders under indefinite-delivery, indefinite-quantity contract N00024-07-D-4002 that clearly describe all services to be performed and supplies to be delivered and establish the full price for the performance of the work (see Finding B);

and b. Establish a fixed-fee amount when issuing task orders for repair parts;

c. Negotiate fair and reasonable prices for repair parts on all future orders.

2. Perform a review, and as appropriate initiate, administrative action against the contracting officer in accordance with Federal Acquisition Regulation Subpart 1.602-1(b), “Authority,” for:

a. allowing a prohibited cost-plus-a-percentage-of-cost system of contracting,

b. improperly “banking” funds on the contract [Finding B], and

c. not developing a quality assurance surveillance plan or appointing a contracting officer’s representative in country [Finding C].

Management Comments Required

The Naval Sea Systems Command Executive Director for Contracts did not comment on a draft of this report. We request that the Naval Sea Systems Command Executive Director for Contracts provide comments on the final report.

Finding B. Inappropriate Financial Management

The NAVSEA contracting officer did not properly manage IDIQ contract N00024-07-D-4002. This occurred because the contracting officer “banked” approximately \$20.3 million in Navy O&M funds when he issued task orders for the purpose of obligating funds before specific requirements were identified. Eventually, the COR issued technical instructions that defined the requirements for approximately \$19.2 million of the banked funds. The remaining \$1.1 million in Navy O&M funds from FY 2007, FY 2008, and FY 2009 are invalid unliquidated obligations and, if expended, could result in potential bona fide needs rule violations.

In addition, the contracting officer’s failure to negotiate prices or definitize requirements in a timely manner for those task orders associated with cost reimbursable work led to using the prohibited cost-plus-a-percentage-of-cost system of contracting (see Finding A).

Background

An obligation is the amount of an order placed, contract awarded, or service received during an accounting period that requires payment during the same, or a future period. It is recorded when an authorized agent of the Federal Government enters into a legally binding agreement to purchase specific goods or services. The recorded obligation reduces by the amount of payments made on bills received. The obligated balance still owed is the unliquidated balance. When all services or goods have been received and paid for, the obligation is considered “liquidated,” and any remaining balance should be deobligated to make the funds available for other uses. However, funds can only be obligated in the fiscal years for which they are available or used for adjustments to or payments of existing obligations. Operation and Maintenance appropriations are available for obligation for one fiscal year, available for expenditure for the next five fiscal years, and canceled at the end of the fifth year after expiration of the appropriation. Canceled funds are not available for expenditure for any reason.

Criteria

The FAR provides the requirements for issuing task orders under an IDIQ contract. In addition, the DOD Financial Management Regulation (FMR) establishes how bona fide needs rule violations and Antideficiency act violations could occur.

Federal Acquisition Regulation

FAR Subpart 16.504, “Indefinite-Quantity Contracts,” states that

an indefinite-quantity contract provides for an indefinite quantity, within stated limits, of supplies or services during a fixed period. The Government places orders for individual requirements. Quantity limits may be stated as number of units or as dollar values.

- A solicitation and contract for an indefinite quantity must—
- i. Specify the period of the contract, including the number of options and the period for which the Government may extend the contract under each option;
 - ii. Specify the total minimum and maximum quantity of supplies or services the Government will acquire under the contract;
 - iii. Include a statement of work, specifications, or other description, that reasonably describes the general scope, nature, complexity, and purpose of the supplies or services the Government will acquire under the contract in a manner that will enable a prospective offeror to decide whether to submit an offer; [and]
 - iv. State the procedures that the Government will use in issuing orders
- ...

FAR Subpart 16.505, “Ordering,” states that

the contracting officer does not synopsise orders under an indefinite-delivery contract . . . [but must] clearly describe all services to be performed or supplies to be delivered so the full cost or price for the performance of the work can be established when the order is placed. Orders shall be within the scope, issued within the period of performance, and be within the maximum value of the contract.

Orders placed under indefinite-delivery contracts must contain the following information:

- i. Date of order.
- ii. Contract number and order number.
- iii. For supplies and services, contract item number and description, quantity, and unit price or estimated cost or fee.
- iv. Delivery or performance schedule.
- v. Place of delivery or performance . . . ;
- vi. Any packaging, packing, and shipping instructions.
- vii. Accounting and appropriation data.
- viii. Method of payment and payment office, if not specified in the contract.

DOD Financial Management Regulation

DOD FMR, volume 3, chapter 8, “Standards for Recording and Reviewing Commitments and Obligations,” states that each dormant unliquidated obligation of \$50,000 or more shall be reviewed to determine if: the recorded obligation amount is accurate, the unliquidated amount is valid, and for goods and services received or provided, accrued expenditures or accrued earnings are reconciled with related accounts payable and accounts receivable accounts.

DOD FMR, volume 14, chapter 1, “Administrative Control of Appropriations,” states that DOD officials cannot authorize an obligation or make an expenditure beyond the permitted amount. Specifically, DOD officials must “ensure that the obligation and expenditure of funds provide for a bona fide need of the period of availability of the fund or account.”

DOD FMR volume 14, chapter 2, “Violations of the Antideficiency Act,” states that a violation of the Antideficiency Act can occur if “obligations or expenditures of funds do not provide for a bona fide need of the period of availability of the fund or account and corrective funding is not available.”

Risk Associated With Banking Funds

The contracting officer intentionally banked \$20.3 million on task orders instead of clearly describing all services to be performed, supplies to be delivered, or establishing the full price for the performance of the work in accordance with FAR Subpart 16.505. The contracting officer disregarded the fundamental guiding principles of funds management by banking funds for future use and before requirements were determined. The contracting officer’s process violates FAR and DOD FMR guidance for placing orders and obligating funds for individual requirements. Consequently, the contracting officer obligated funds via task order that did not identify requirements; the task orders may not, therefore, meet a bona fide need and may result in an Antideficiency Act violation.

The contracting officer disregarded the fundamental guiding principles of funds management by banking funds for future use and before requirements were determined.

Contracting Officer’s Improper Actions

The contracting officer issued task orders for engineering services under the contract to bank approximately \$20.3 million in O&M funds. The task orders functioned as a way to bank funds rather than to place actual orders. Each task order that was issued acted as a separate account that was then drawn down through the issuance of technical instructions when an actual need arose. In addition, the COR maintained a “checkbook” that kept track of the balance of each task order minus the technical instructions to ensure the task order was not overdrawn, much like a checkbook for a bank account would be used.

The contracting officer did not clearly describe all services to be performed, supplies to be delivered, or establish the full price for the performance of the work when he issued task orders on the IDIQ contract. According to the requirement in the IDIQ contract, the contractor would provide all services as needed when directed by task order for the M-Class diesel engines; the task order would include an attachment specifying the need for engineering services for work to be performed in Bahrain. However, the nine task orders for engineering services,³ valued at approximately \$20.3 million, did not include a statement of work or statement specifying the need for engineering services. For example, task order 0002 contained the following three CLINs and not-to-exceed

³ These engineering services were for work performed in Bahrain, Japan, and one task order for Texas. We included the Japan and Texas engineering services in our review because the problems with the task orders were the same as the ones for Bahrain.

amounts: CLIN 0007AB, for Engineering Services in Bahrain, \$54,000; CLIN 0008AB, for Engineering Services in Japan, \$30,000; and, CLIN 0009AA, Support for CLINs 0005–0008, \$50,000. However, task order 0002 did not specify any work for the diesel engines that needed the contractor’s immediate attention and did not identify the specific ship the work would be performed on. As a result, the task orders did not document the specific work to be performed or establish the exact cost of work required.

We asked the NAVSEA contracting personnel why the task orders did not have specific work requirements and established prices and quantities for those requirements. According to NAVSEA contracting personnel, when NAVSEA received Navy O&M funds, the contracting officer obligated those funds immediately on task orders under the contract. They stated that the purpose of issuing a task order under the contract was to obligate money to a particular CLIN and that rather than establishing the statement of work and definitized cost for each task order, the COR issued technical instructions under the task orders to direct the contractor to begin work when a specific need arose on a ship. They stated that the technical instructions better defined the work requirements and functioned as the actual statement of work.

NAVSEA Technical Instructions

We reviewed the technical instructions and determined that the technical instructions definitized the work because they described the specific work required and established the prices and quantities for the requirements. For example, technical instruction 4002-07-32B, dated September 21, 2007, issued under task order 0002, authorized the contractor to implement a full service trial to perform preventative maintenance, repair planning, repairs, data analysis, and ships’ force mentoring and training aboard the USS *Dextrous* (MCM-13). Technical instruction 4002-07-32B established the price for work, \$955,192, based on the contractor’s estimate and included a statement of work with general and specific requirements for the full service trial.

Based on NAVSEA’s use of task orders and technical instructions, the technical instructions functioned as the actual task orders while the task orders themselves functioned as IDIQ contracts that allowed the Navy to bank money for future requirements. The future requirements were established later through technical instructions issued by the COR rather than the contracting officer. We determined that the contractor had been paid \$12.6 million of the \$20.3 million in O&M funds. We determined that \$6.6 million of the \$7.7 million unliquidated obligations balance had an identifiable requirement and were, therefore, valid unliquidated obligations. The remaining \$1.1 million in unliquidated obligations is invalid because requirements for the \$1.1 million had not been identified.

This occurred because the contracting officer did not issue task orders in accordance with FAR Subpart 16.505. The \$1.1 million should be deobligated. See Table 3 for the \$1.1 million by fiscal year.

The remaining \$1.1 million in unliquidated obligations is invalid because requirements for the \$1.1 million had not been identified.

Table 3. NAVSEA Obligations and Expenditures

	FY 2007	FY 2008	FY 2009	Total
Amount obligated on task orders	\$1,759,192	\$15,454,734	\$3,111,360	\$20,325,286
Amount paid for task orders	\$893,497	\$9,633,870	\$2,121,978	\$12,649,345
Valid unliquidated obligations supported by TIs	\$558,354	\$5,399,366	\$647,087	\$6,604,807
Invalid unliquidated obligations unsupported by TI	\$307,341	\$421,498	\$342,295	\$1,071,134

Conclusion

The contracting officer intentionally banked \$20.3 million on task orders that did not identify specific requirements as required by FAR 16.505. By banking funds on undefinitized task orders, the contracting officer increased the risk that bona fide needs rule violations could occur and prevented \$1.1 million of the \$20.3 million from being put to better use. The contracting officer should have deobligated the unused funds once the technical instructions were issued.

Recommendations

B. We recommend that the Naval Sea Systems Command Executive Director for Contracts:

1. Direct the contracting officer for contract N00024-07-D-4002 to:

- a. Stop issuing task orders that “bank” money; issue task orders in accordance with Federal Acquisition Regulation Subpart 16.505, “Ordering.”
 - b. Verify and deobligate the dollar value of the invalid unliquidated obligations on contract to reduce the risk of a potential bona fide needs rule violation.
2. Review all ongoing Naval Sea Systems Command indefinite delivery, indefinite quantity contracts as part of good financial management practices to ensure that task orders are being issued in accordance with Federal Acquisition Regulation Subpart 16.505 and not as a tool to bank funds.
3. Establish procedures for all Naval Sea Systems Command contracts to discontinue the practice of issuing task orders that “bank” funds in anticipation of future needs.

Management Comments Required

The Naval Sea Systems Command Executive Director for Contracts did not comment on a draft of this report. We request that the Naval Sea Systems Command Executive Director for Contracts provide comments on the final report.

Finding C. Insufficient Quality Assurance

~~(FOUO)~~ The contracting officer did not provide sufficient surveillance and acceptance for six task orders, valued at approximately [REDACTED],⁴ for engineering services performed in Bahrain. Specifically, the contracting officer failed to develop a quality assurance surveillance plan (QASP) for the overall IDIQ contract or the task orders issued under it, designate an on-site contracting officer's representative (COR) to oversee contractor work, and establish lines of communication and expectations for surveillance and acceptance for Navy representatives on site. This occurred because the contracting officer was unaware of his responsibilities to provide surveillance for the task orders. In addition, the contracting officer relied on the COR, located in the United States, to make decisions for the overall IDIQ contract and task orders that should have been made by the contracting officer. As a result, there is no assurance that the Navy received the [REDACTED] in contracted for supplies and services.

Quality Assurance Surveillance Plan Criteria

FAR Subpart 37.604, "Quality Assurance Surveillance Plans," states the Government may either prepare the QASP or require the offerors to submit a proposed QASP for the Government's consideration.

FAR Subpart 46.103, "Contracting Office Responsibilities," states that the contracting office is responsible for ensuring the QASP is created based on specifications for inspection, testing, and other contract quality requirements essential to ensure the integrity of the supplies or services provided by the activity responsible for technical requirements.

FAR Part 46.401, "General," states that a QASP "should be prepared in conjunction with the preparation of the statement of work" and "should specify all work requiring surveillance; and the method of surveillance." The QASP is a document that allows the Government to determine that the supplies and services provided by the contractor conform to contract requirements. The plan identifies all the work requiring surveillance and how the surveillance will be performed. Each contract designates the place where the Government reserves the right to perform quality assurance. If the Government inspects the supplies other than at destination, the supplies should be re-examined for quantity, damage in transit, and possible substitution or fraud at destination. An inspection report, receiving report, or commercial shipping packing list documents the Government inspection.

⁴~~(FOUO)~~ The [REDACTED] is specific only to engineering services performed in Bahrain under the contract. The [REDACTED] includes the amount obligated specifically for engineering services in Bahrain as well as the amount of funds obligated for support for engineering services in Bahrain. See Appendix A for a detailed description of how we calculated the [REDACTED]

Quality Assurance Surveillance Plan Not Developed

The contracting officer did not develop a QASP for contract N00024-07-D-4002 or any of the task orders issued under the contract. The contracting officer stated that he was unaware of the FAR requirement for the contracting officer to develop a QASP and ultimately relied on a NAVSEA individual, who is now the COR for the contract, to make the determination that a QASP was not required. However, during a review of the contracting file, we found evidence that the contracting officer considered developing a QASP for the contract, but let the COR make the determination to not develop a QASP. The contracting officer asked the COR via e-mail during the presolicitation phase whether a QASP needed to be developed for the contract. The COR responded that the NAVSEA standard items invoked in the basic contract qualified as the QASP.

The NAVSEA standard items did not meet the FAR requirements for a QASP. For example, NAVSEA standard item No. 009-67 provided the detail for each of the items the contractor was supposed to develop and/or manage. These requirements were for the contractor to perform, not for the Government to perform. Nowhere in the NAVSEA standard item document did it state that the work listed in the document requires surveillance or outlines how the surveillance will be conducted by Government personnel. FAR Subpart 46.401 (e), "General," states that "Government inspection shall be performed by or under the direction or supervision of Government personnel," not the contractor. In addition, attached to NAVSEA standard item No. 009-67 was a test performance responsibility-witness record for documenting test procedures performed by the contractor, ship's force, or Government personnel and the results of the test. Although this test performance record can be accomplished by Government personnel, the NAVSEA standard item did not identify specific items for the Government to perform surveillance on and did not specify how the surveillance should be performed as required by FAR Part 46.401. Therefore, the NAVSEA standard items did not qualify as the QASP, and the contracting officer should have developed a QASP. There was no indication in the contract file that the contracting officer reviewed the NAVSEA standard items to determine whether the NAVSEA standard items included the elements of a QASP.

The COR also provided us with the contractor's quality plan, issued by FMSNA. According to FAR Subpart 37.604, the Government may either prepare the QASP or require the offerors to submit a proposed QASP for the Government's consideration. We reviewed the quality plan provided by the COR and found no evidence that the Government approved the plan. FAR Subpart 46.401 states that the QASP should specify the work requiring surveillance and the method of surveillance. The quality plan stated that it applies to the performance, verification, and reporting of all services and repair operations concerning the quality assurance department and the diesel engine department within FMSNA. The quality plan stated that it applies to all services; however, it did not specify the specific work requiring surveillance. The quality plan specified documents used by the contractor for surveillance, such as a subcontractor evaluation form. FAR Subpart 46.401 states that "Government inspection shall be performed by or under the direction or supervision of Government personnel," not the

contractor. The quality plan provided by the COR did not qualify as a QASP because it was not approved by a Government representative, did not contain specific work requiring surveillance, and was for contractor internal use.

The contracting officer should have made a determination as to whether the NAVSEA standard items and the contractor's quality control plan met the FAR requirements for a QASP because he is ultimately responsible for the contract quality assurance. In order to ensure that the Navy receives the services it is paying for, the contracting officer should develop a QASP for the measurable evaluation of the contractor's performance.

Contracting Officer's Representative – Roles and Responsibilities

The FAR, Defense Federal Acquisition Regulation Supplement (DFARS), and NAVSEA Instruction 4200.17C provide guidance on the roles and responsibilities of the COR.

FAR

We reviewed the FAR to determine authority granted only to contracting officers that would not be delegable to CORs. We used this criteria to determine whether the COR was overstepping his authority as the COR.

FAR Subpart 1.602-1, "Authority," states that "contracting officers have authority to enter into, administer, or terminate contracts and make related determinations and findings. Contracting officers may bind the Government only to the extent of the authority delegated to them. Contracting officers shall receive from the appointing authority clear instructions in writing regarding the limits of their authority."

Defense Federal Acquisition Regulation Supplement

DFARS 201.602-2, "Contracting Officers Responsibilities," states that a COR "must be qualified by training and experience commensurate with the responsibilities to be delegated in accordance with . . . agency guidelines." The COR has "no authority to make any commitments or changes that affect price, quality, quantity, delivery, or other terms and conditions of the contract."

"For contract actions for services awarded by DOD component . . . contracting officers shall designate a properly trained COR in writing before contract performance begins." The COR must be a Government employee and have a designation letter that:

- specifies the extent of the COR's authority to act on behalf of the contracting officer,
- identifies the limitations on the COR's authority,
- specifies the period covered by the designation,
- states the authority is not redelegable, and
- states the COR may be held personally liable for unauthorized acts.

Office of the Secretary of Defense

Deputy Secretary of Defense memorandum, “Monitoring Contract Performance in Contracts for Services,” August 22, 2008, states that “trained and ready CORs are critical; they ensure contractors comply with all contract requirements and that overall performance is commensurate with the level of payments made throughout the life of the contract.” Requiring activities must ensure that CORs are properly trained, ready, and are assigned prior to contract award.

NAVSEA Instruction

NAVSEA Instruction 4200.17C, “Contracting Officer’s Representative,” states that a COR “is a technically qualified, properly trained individual . . . appointed in writing by the Procuring Contracting Officer (PCO) to serve as liaison between the Government and a contractor for the technical aspects of a specific contract or order. The COR monitors the contractor’s performance, serves as the focal point for the resolution of technical issues, and provides technical and administrative support to the contracting officer.” “To ensure adequate surveillance of contractor performance under service contracts . . . the [contracting officer] may designate a COR, in writing . . . [or the contracting officer] shall assume COR responsibilities on an interim basis until an available, qualified COR can be appointed.”

The COR is responsible for:

- a) monitoring the contractor’s technical compliance and progress and identifying promptly to the [contracting officer] all observed substantive deficiencies not in compliance with contract/delivery order terms and conditions;
- b) ensuring that all technical instructions issued to the contractor are otherwise within the scope of the contract statement of work and available funds, and are in writing;
- c) acting as coordinator, maintaining records of and ensuring the acceptability of all specified contract deliverables;
- d) maintaining records of and reviewing invoices to ensure the general appropriateness of types and quantities of labor and material to the task being performed;
- f) maintaining running tallies of expended man-hours and dollars compared to awards for each TI [technical instruction] along with cumulative tallies for each contract for which the COR is assigned COR responsibilities.

Insufficient Contract Surveillance

The contracting officer properly designated by letter on September 24, 2007,⁵ the current qualified COR for contract N00024-07-D-4002 in accordance with DFARS 201.602-2, “Contracting Officers Responsibilities.” However, the COR did not fulfill his duties as a COR and monitor the contractor’s performance in accordance with Deputy Secretary of

The COR . . . did not travel to Bahrain to monitor the contractor’s performance because the contracting officer did not think the COR needed to be on site.

Defense and NAVSEA guidance. The COR was located at the Navy Yard, Washington D.C., and did not travel to Bahrain to monitor the contractor’s performance because the contracting officer did not think the COR needed to be on site. The COR told us he relied on the project manager (surveyor) or port engineer for contract surveillance; however, he did not receive any surveillance documentation verifying that the work was complete, accurate, and

acceptable. He stated he knew the work was completed when the ship was operational. We verified that material inspection and receiving reports, DD Form 250,⁶ were submitted in the Wide Area Work Flow database along with the contractor’s invoices; however, the contracting officer stated he never saw any DD 250s for the contract and was unsure whether the contractor submitted DD 250s in the Wide Area Work Flow database along with the invoices.

Although the COR stated that he relied on the project manager for contract surveillance, the project manager did not perform sufficient contract surveillance. The Mid-Atlantic Regional Maintenance Center (MARMC)⁷ supervisor surveyor (project manager) stated that he was not delegated responsibility for contractor surveillance for contract N00024-07-D-4002; however, he stated that he signed the DD 250s to help the COR. The project manager stated that there was no way for the MARMC surveyors to verify labor hours and that he did not have the manpower to verify every part used by the contractor for the work performed. This method did not result in sufficient quality assurance. The COR should not have relied on the project manager to ensure the contractor was meeting contract quantity and quality standards.

⁵ Contract N00024-07-D-4002 had multiple CORs assigned over the life of the contract. The first COR was designated by letter on January 13, 2005, prior to contract award in October 2006.

⁶ DD 250s, material inspection and receiving reports, are submitted by the contractor specifying the service performed and the amount being billed for. The official responsible for contract quality assurance signs the form certifying that the services were completed.

⁷ On October 1, 2009, as a result of the Base Realignment and Closure, MARMC was subsumed by the Norfolk Naval Shipyard, and the Commander, Regional Maintenance Center, was realigned under NAVSEA. As a result, MARMC changed its name to Norfolk Ship Support Activity. We will use the MARMC acronym throughout the report for consistency.

Inappropriate Authorization of Payment

The COR stated that he relied on port engineers⁸ to verify that services were completed. We determined that the port engineers relied on the MARMC surveyors to determine when services were completed; however, the MARMC surveyors did not perform sufficient contract surveillance. Therefore, overall contract surveillance was inadequate. We determined through meetings with the port engineers that the port engineers planned the ships' maintenance schedules and set priorities for repairs and maintenance. The port engineers also validated the work requested on the ships and forwarded the validated work requests to the MARMC surveyors. One port engineer told us that he marked the work requests as complete when the surveyor reported back that work was completed. We determined, however, that the MARMC surveyors were not delegated contract surveillance responsibility under contract N00024-07-D-4002 and did not perform sufficient contract surveillance. Therefore, the COR should not have relied on the port engineers to verify that services were completed. Without sufficient contract surveillance, payment may have been authorized for services that did not meet contract requirements.

... payment may have been authorized for services that did not meet contract requirements.

Unauthorized Duty

In addition, the contracting officer allowed the COR to perform an unauthorized duty by issuing technical instructions under the contract. Since the technical instructions actually include all the elements of actual task orders, the contracting officer allowed the COR to enter into contracts for the Government as if he were a contracting officer. FAR Subpart 1.602-1, "Authority," states that only contracting officers have authority to enter into, administer, or terminate contracts. Further, DFARS 201.602-2, "Contracting Officer's Responsibilities," states that the COR has no authority to make any commitments or changes that affect price, quality, quantity, delivery, or other terms and conditions of the contract. However, the price, quality, quantity, delivery, and other terms and conditions were established by the technical instructions because of the contracting officer's inappropriate use of the IDIQ contract (see Finding B). As a result, the COR performed an unauthorized duty that was the contracting officer's responsibility. The contracting officer should not have allowed the COR to obligate the Government, set the terms of the contract, or direct the contractor to perform work.

Conclusion

The contract lacked any formal qualitative and quantitative surveillance. The contracting officer did not develop a QASP for formal quality assurance, and the COR did not monitor the contractor's performance. The COR relied on the MARMC project manager or port engineers located in Bahrain with the contractor to perform quality assurance;

⁸ The port engineers are contractor personnel under contract N00178-05-D-4635 for port engineering services.

~~(FOUO)~~ however, these individuals did not perform sufficient surveillance of the contractor. The contracting officer also allowed the COR to exceed his authority and direct the contractor to perform work through issuing technical instructions. Consequently, the Navy has no assurance that approximately [REDACTED] in services performed by the contractor met contract quality and quantity standards.

Recommendations

C. We recommend the Naval Sea Systems Command Executive Director for Contracts direct the contracting officer for contract N00024-07-D-4002 to:

1. Develop a quality assurance surveillance plan for the measurable and consistent evaluation of contractor performance in Bahrain for task orders and technical instructions under contract N00024-07-D-4002.
2. Assign a contracting officer's representative in theatre to perform quality assurance for all task orders and technical instructions issued under contract N00024-07-D-4002.
3. Enforce the contracting officer's representative's limitations as stated in the Federal Acquisition Regulation and the contracting officer's representative's designation letter and not allow the contracting officer's representative to act as the contracting officer and obligate the Government.

Management Comments Required

The Naval Sea Systems Command Executive Director for Contracts did not comment on a draft of this report. We request that the Naval Sea Systems Command Executive Director for Contracts provide comments on the final report.

Finding D. Necessary Certified Data Not Provided by Contractor

Since FY 2008, FMSNA has not provided the contracting officer with certified cost or pricing data to negotiate costs on interdivisional transfers of spare parts from an affiliated company. The contracting officer took appropriate action by withholding payment from FMSNA; however, he had not elevated the contractor's denial to the NAVSEA Executive Director for Contracts. The Navy could be overcharged if negotiations occur without the contractor providing the required cost information. The contracting officer needs to elevate the issue to more senior officials because FMSNA has not provided cost or pricing data on prior contracts (see Appendix C), and this contract has the potential to set a precedent for FMSNA to obtain future Government contracts (see Appendix B).

Criteria

The FAR provides guidance for determining whether a contractor is a responsible contractor and for obtaining cost or pricing data. The DFARS provides guidance for obtaining cost or pricing data when the contracting officer is unable to obtain information to determine price reasonableness.

FAR

FAR Subpart 2.101, "Definitions," defines:

- *Affiliates* as "associated business concerns . . . if, directly or indirectly . . . a third party controls or can control both."
- *Commercial item* as "any item, other than real property, that is of a type customarily used by the general public or by non-governmental entities for purposes other than governmental purposes" and either "has been sold, leased, or licensed . . . or has been offered for sale, lease, or license to the general public." A commercial item can be "any item that evolved from" the previous description "through advances in technology . . . and that is not yet available in the commercial marketplace, but will be available in the commercial marketplace in time to satisfy the delivery requirements" of the Government contract. A commercial item can also be any item that would normally meet the previous two definitions, and has "modifications of a type customarily available" to the general public or "minor modifications of a type not customarily available" to the general public. A minor modification is a modification that does "not significantly alter the non-governmental" purpose of an item.

FAR Part 9.103, "Policy," states that the contracting officer must make a determination as to whether the contractor is responsible before awarding a contract.

FAR Subpart 9.104-1, "General Standards," requires the contractor to have a satisfactory record of integrity and business ethics, and a satisfactory performance record to be

considered responsible. FAR Subpart 42.1501, “General,” states that a satisfactory performance record includes the contractor’s “history of reasonable and cooperative behavior and commitment to customer satisfaction,” and “record of integrity and business ethics.”

FAR Part 15.403, “Obtaining Cost and Pricing Data,” states that “the contracting officer shall not require the submission of cost or pricing data” for any action “when a commercial item is being acquired.”

FAR Subpart 31.205-26, “Material Costs,” states that the allowable amount “for all materials . . . sold or transferred between . . . affiliates . . . shall be on the basis of cost incurred . . .” However, the allowable amount may be based on price when “it is the established practice of the transferring organization to price interorganizational transfers at other than cost . . . and the item . . . qualifies for an exemption under [FAR] 15.403-1(b) and the contracting officer has not determined the price to be unreasonable.”

DFARS

DFARS 215.404-1, “Proposal Analysis Techniques,” states that when a contracting officer cannot obtain information from the contractor to determine price reasonableness the following steps should be taken:

- A. The contracting officer should make it clear what information is required and why it is needed to determine fair and reasonable prices, and should be flexible in requesting data and information in existing formats with appropriate explanations from the offeror.
- B. If the offeror refuses to provide the data, the contracting officer should elevate the issue within the contracting activity.
- C. Contracting activity management shall, with support from the contracting officer, discuss the issue with appropriate levels of the offeror’s management.
- D. If the offeror continues to refuse to provide the data, contracting activity management shall elevate the issue to the head of the contracting activity for a decision in accordance with FAR Subpart 15.403-3 . . . , [Requiring Information Other Than Cost or Pricing Data].
- E. The contracting officer shall document the contract file to describe—
 - 1) the data requested and the contracting officer’s need for that data;
 - 2) why there is currently no other alternative but to procure the item from this particular source; and
 - 3) a written plan for avoiding this situation in the future.

Spare Parts Dispute

~~(FOUO)~~ The contracting officer has not authorized payment for approximately [REDACTED] in parts purchased from FMSNAs affiliate, Issota Fraschini Motori (IFM), because FMSNA has not provided documentation to support its claimed costs. The

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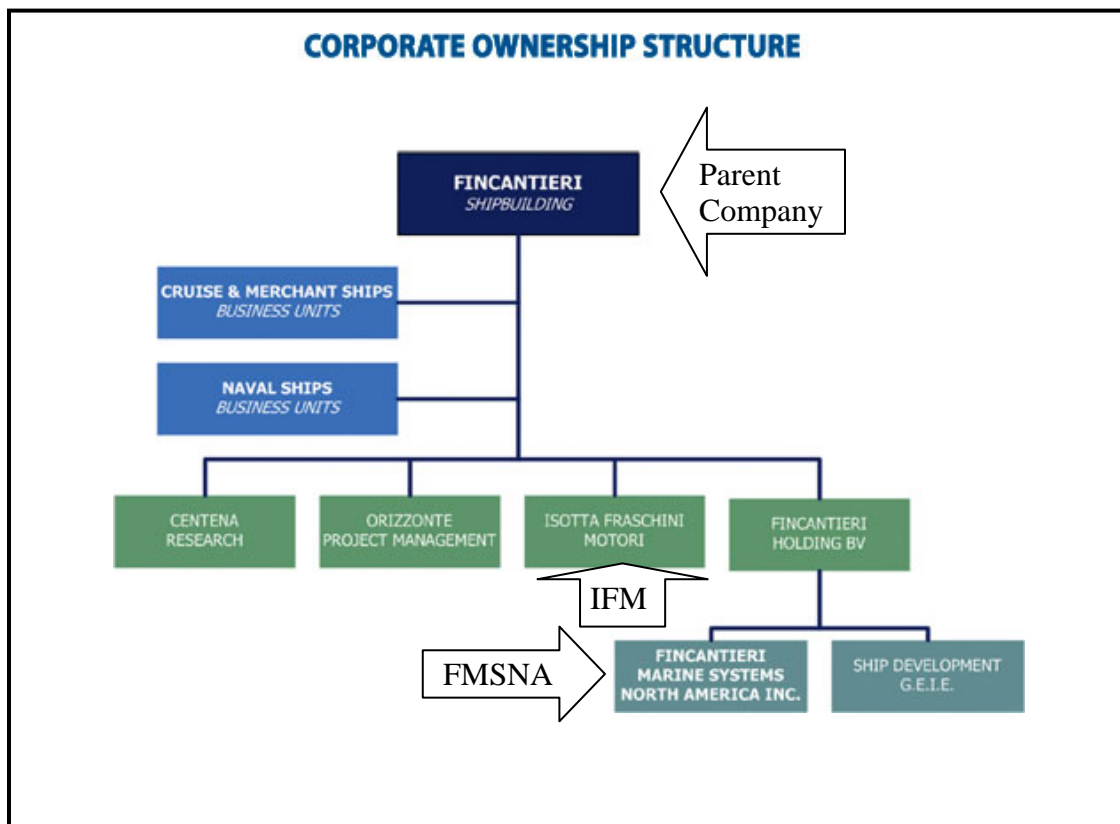
contracting officer believes that FMSNA is charging the Government twice for profit on repair parts obtained from IFM and has requested cost and pricing data to support that IFM has not charged FMSNA profit on the parts. In a letter to FMSNA dated, October

FMSNA has refused to provide cost or pricing data for IFM parts . . .

20, 2008, the contracting officer requested that the contractor provide certified cost or pricing data showing the breakdown of the cost of parts FMSNA purchased from IFM. FMSNA has refused to provide cost or pricing data for IFM

parts, claiming that it is not required to provide cost or pricing data because the parts in question are commercial items, and FMSNA and IFM are not under common control of Fincantieri.⁹ See the figure for a Fincantieri Corporate organizational chart that shows the relationship of FMSNA and IFM under the parent company Fincantieri.

Figure. Fincantieri Organization Chart



This organization chart was obtained from FMSNA's Web site,
<http://www.fincantierimarinesystems.com/org.htm>, on April 16, 2010.

⁹ Fincantieri Cantieri Navali Italiani S.p.A., the parent company, wholly owns Fincantieri Holding B.V., which wholly owns FMSNA. FMSNA was formerly FDGM, Inc. When Fincantieri formed FMSNA, FMSNA absorbed FDGM, Inc. and all obligations, contracts, and commitments of FDGM, Inc. became the responsibility of FMSNA.

~~(FOUO)~~ The approximate cost of the parts in dispute was [REDACTED] as of July 1, 2008. We calculated the approximate cost of the spare parts in dispute by analyzing the task orders issued under contract N00024-07-D-4002 to determine the parts used. We obtained a listing of part numbers, unit prices, quantity used under contract N00024-07-D-4002, and the total price for the quantity used for each part from the contracting officer. We calculated the total price associated with each part used to determine the amount of the disputed parts was approximately [REDACTED]. The [REDACTED] does not include material handling, general and administrative fees, and profit added to the base cost of the parts under the contract. As of July 11, 2009, FMSNA requested payment of [REDACTED]¹⁰ for all parts transferred from IFM to FMSNA and furnished to the Navy under contract N00024-07-D-4002. FMSNA did not provide a breakdown of the costs that made up the [REDACTED]. While material handling and general and administrative fees and profit are allowed under the contract, FAR Subpart 31.205-26, "Material Costs," prohibits IFM from charging profit on parts transferred to FMSNA as part of the contract. If allowed, the Government would be charged twice for profit. In addition, the contracting officer executed the engine repair CLINs as a prohibited cost-plus-a-percentage-of-cost contract (see Finding A). As a result, the contracting officer has incentivized FMSNA to maximize the cost of repair parts under the contract.

Commerciality of Spare Parts

In a letter to the contracting officer, dated August 20, 2008, FMSNA claimed that the engines sold to the U.S. Navy were a modified version of the engines sold to commercial customers; therefore, the engines sold to the U.S. Navy qualified as commercial items. In addition, FMSNA claimed that the parts used in the engines supplied to the U.S. Navy were parts "of a type" used in those engines that were sold commercially. Further, FMSNA stated that because those engines were commercial items, the parts in question would also be commercial items as none of the parts supplied to the U.S. Navy were made to Government specifications.

The contracting officer stated in a letter to FMSNA, dated October 24, 2008, that, in accordance with FAR Subpart 31.205-26, "Material Costs," FMSNA must meet the criteria of the following two-part test in order to provide interorganizational transfers at price.

- It is the established practice of IFM to price interorganizational transfers at other than cost for commercial work of FMSNA.
- The repair parts being transferred qualify for an exception under FAR Subpart 15.403-1 (b), "Exceptions to cost or pricing data requirements."

The contracting officer stated with regard to the two-part test, that FMSNA did not provide any information to support whether or not it had an established practice of making interorganizational transfers at a price other than cost. In addition, FMSNA had

¹⁰ ~~(FOUO)~~ The amount of [REDACTED] was provided by FMSNA on July 11, 2009.

not provided any documentation to support that the parts transferred from IFM were actually commercial; FMSNA merely stated the parts were commercial without providing any documentation to support its claim. The contracting officer stated that he determined that the engines provided to the U.S. Navy were not commercial engines but unique Navy engines that had significant modifications not customarily available on the commercial market. Since the contracting officer determined that the parts were not commercial, the contracting officer was required to request the submission of cost or pricing data under FAR Subpart 15.403-1(c)(3).

Common Control

In addition to their claim that the parts sold by IFM were commercial items, FMSNA officials contended that the FAR did not require them to provide cost or pricing data because FMSNA and IFM were not “affiliates” or under “common control,” but were separate entities that conducted business at an “arm’s length.” FAR Subpart 31.205-26(e), “Material Costs,” states that materials, services, and supplies sold or transferred between affiliates under common control may be allowed at other than cost or price when it is the established practice of the transferring organization to price interorganizational transfers at other than cost for commercial work. FMSNA officials believed that they were allowed to charge the Navy the price that IFM charged them for parts because there was no common control between the two companies; no third party exercised actual control over both, nor did either control the other. In a letter to the contracting officer, dated August 20, 2008, FMSNA stated for the first time that it was not under common control with IFM. Furthermore, FMSNA stated in the letter that the meaning of the terms “divisions, subdivisions, subsidiaries, or affiliates” was unknown because FAR 2.101 did not define any of those terms. FAR Subpart 2.101 did in fact define affiliates as associated business concerns if, directly or indirectly, a third party controls or can control both.

The contracting officer determined that FMSNA and IFM were under common control and explained to FMSNA in a letter, dated October 24, 2008, that it did not matter whether the parent company actually exercised control over FMSNA and IFM, but rather that the parent company had the ability to exercise that control. In addition, the contracting officer stated that there was a commonality of various key members on some of the Boards of Directors within the Fincantieri organization. The contracting officer pointed out the common names and their various positions within the Fincantieri organization in a letter to FMSNA, dated December 5, 2008.

In addition, in two separate Defense Contract Audit Agency (DCAA) reports, both FDGM¹¹ and IFM stated that they were wholly owned and controlled by Fincantieri S.p.A. In FDGM’s response to DCAA Report 01661-2004D42000003, “Report on Postaward Audit,” May 2, 2006, FDGM stated that it was wholly owned and controlled by Fincantieri Holding B.V., which was wholly owned and controlled by Fincantieri S.p.A. FDGM also stated that IFM was wholly owned and controlled by Fincantieri

¹¹ FMSNA was formerly FDGM, Inc.

S.p.A. FDGM explained that the relationship between FDGM and IFM made the two companies affiliates, as defined by FAR Subpart 2.101. In IFM's response to DCAA Report No. 2191-2004G42000003, "Report on Post Award Review of Intra-Company Work Order Cost or Pricing Data," February 10, 2006, IFM explained that it was wholly owned and controlled by Fincantieri Cantieri Navali Italiani S.p.A. IFM also stated that Fincantieri wholly owned and controlled FDGM through its fully owned subsidiary Fincantieri Holding B.V., thus IFM and FDGM were "sister" companies. For more information on the DCAA reports, see Appendix C. We believe the contracting officer should request DCAA to review any cost data obtained from FMSNA.

When asked about their argument and their responses to DCAA audit reports, FMSNA officials stated that the DCAA audit reports applied only to FDGM. However, when Fincantieri formed FMSNA, FMSNA absorbed FDGM and all obligations, contracts, and commitments of FDGM became the responsibility of FMSNA. Therefore, FDGM and FMSNA were the same, and FDGM's response to DCAA also addressed FMSNA.

We also reviewed four separate, slightly different, Fincantieri organization charts to determine the organizational structure of the company and the relationship between FMSNA and IFM. When asked to explain the correct organizational structure of Fincantieri, FMSNA personnel explained that the organizational chart found on FMSNA's Web site was incorrect and a simplistic depiction of the organization and that the organizational chart would be updated as soon as possible. In a meeting between the audit team and FMSNA on July 7, 2009, FMSNA personnel stated that the organizational structure changed in January 2009, yet the organizational chart remained unchanged as of April 16, 2010, on the Web site (see the figure). Although each organizational chart was different, each showed Fincantieri as the parent company of both FMSNA and IFM.

The Fincantieri 2007 and 2008 annual reports showed that Fincantieri directly owned 100 percent of IFM and owned 100 percent of Fincantieri Holding B.V., which in turn owned 100 percent of FMSNA. In addition, the 2007 consolidated annual report explained the basis of consolidation by stating that Fincantieri included the financial statements of subsidiaries over which it exercised direct or indirect control in the consolidation. Fincantieri further defined control as when it directly or *indirectly* owned the majority of voting rights or the *ability* to determine the financial and operating decisions of the entity and profits from the resulting benefits. Fincantieri included FMSNA and IFM in the consolidated companies. As a result, the evidence supported the contracting officer's decision that the companies were under common control.

Contracting Officer's Efforts to Resolve Dispute

We asked the contracting officer whether he had taken any additional steps outlined in DFARS 215.404-1¹² (see page 24 for DFARS criteria) for obtaining information from FMSNA to determine price reasonableness other than issuing letters on October 24, 2008

¹² We determined that although DFARS 215.404-1 is titled, "Proposal Analysis Techniques," the criteria could be used to obtain information to determine price reasonableness at any time.

and December 5, 2008, to FMSNA explaining the required information to determine fair and reasonable prices. In an e-mail dated January 6, 2010, the contracting officer stated that he did not elevate the dispute within his contracting chain of command because he considered further action under DFARS 215.404-1 not to be appropriate at that time. Specifically, he stated that FMSNA appeared to have dropped the issue and had not requested negotiations to agree on pricing for the interdivisional transferred parts; therefore, he concluded that there was no need for his management to get involved with what appeared to have been resolved. The contracting officer stated that FMSNA had chosen not to respond to his December 5, 2008 letter; however, it had continued to perform under the contract without mentioning or making any further issue of the payment for IFM interdivisional transferred parts. The contracting officer stated that the correspondence he received from FMSNA on November 12, 2009, was about a restructuring of the company and did not indicate any kind of displeasure, dispute, or grievance against the Navy.

~~(FOUO)~~ However, it is unreasonable to believe that the contractor will not attempt to collect payment for [REDACTED] in spare parts that it believed it was entitled to. In fact, on February 25, 2010, FMSNA officials contacted NAVSEA contracting officials and inquired again about payment for the disputed parts and stated they were willing to provide any supporting documents necessary to resolve the issue. Based on this e-mail, FMSNA has not resolved the issue as stated by the contracting officer. Based on the contractor's response, the contracting officer reiterated to FMSNA that certified cost or pricing data was needed to settle the costs. Because the contracting officer has been unsuccessful in obtaining cost or pricing data, he should elevate the issue to the NAVSEA Executive Director for Contracts as required by DFARS 215.404-1, and if appropriate, the NAVSEA Executive Director for Contracts should elevate the issue to the office of Defense Procurement and Acquisition Policy. Furthermore, O&M funds are only available for payment for 5 years after the end of the fiscal year in which they are obligated; therefore, an Antideficiency Act violation could occur if the contracting officer and FMSNA reach an agreement and payment is made after the funds have expired.

Potential Impact for Future Contracts With FMSNA

Currently under this contract FMSNA officials have not provided certified cost or pricing data to support their claimed costs for interdivisional transfers of spare parts from their affiliate IFM. FMSNA has continued to receive Government contracts despite its questionable business practices because, according to the Navy, FMSNA is the only contractor capable of performing the required work according to Navy standards.

Additionally, under this contract, FMSNA performed a full-service trial on two MCM ships. If the results of the full-service trial are favorable, FMSNA could gain full-service contracts on all 14 MCM ships. Further, FMSNA has positioned itself to acquire full-service contracts on the Navy's fleet of Littoral Combat Ships. The number of Littoral Combat Ships has not been finalized but, according to the naval technology Web site, as many as 60 could be produced. The Navy should resolve this pricing issue with FMSNA prior to awarding future contracts. See Appendix B for more information regarding the full-service trial.

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Conclusion

The contracting officer has attempted to obtain documentation and information to determine fair and reasonable prices for interdivisional transferred parts from IFM to FMSNA because he has determined that FMSNA and IFM are under common control and the parts are not commercial. The contracting officer should elevate the issue to higher authorities to assist in attempting to obtain certified cost or pricing data from FMSNA to resolve the issue before funds expire and a potential Antideficiency Act violation occurs.

Recommendations

D. We recommend that the Naval Sea Systems Command Executive Director for Contracts:

1. Assist the contracting officer in obtaining certified cost and pricing data for the negotiation of fair and reasonable prices on interdivisional transferred parts and not settle the disputed spare parts costs until this data is obtained and reviewed. If the contractor refuses to provide the data, assistance should be requested from the Director, Defense Procurement and Acquisition Policy.

2. Direct the contracting officer to request assistance from the Defense Contract Audit Agency to review any cost and pricing data obtained from Fincantieri Marine Systems North America.

Management Comments Required

The Naval Sea Systems Command Executive Director for Contracts did not comment on a draft of this report. We request that the Naval Sea Systems Command Executive Director for Contracts provide comments on the final report.

Appendix A. Scope and Methodology

We conducted this performance audit from March 2009 through July 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

This is the third in a series of reports on the Army and Navy ship maintenance contracts. We selected a judgment sample of 16 Navy Fleet and Industrial Supply Center, Sigonella task orders issued under 5 contracts and 1 additional Navy Fleet and Industrial Supply Center, Sigonella, contract; 15 Army Mission and Installation Contracting Command-Fort Eustis task orders issued under 1 contract; and 7 NAVSEA technical instructions from FY 2005 through FY 2009 valued at \$96,946,644 based on geographical location and high dollar value. We selected this sample from a universe of 2,934 ship repair and maintenance contracts valued at \$171,901,765. These 2,934 contracts were awarded or modified during FY 2004 through FY 2009 with place of performance located in Southwest Asia. However, during the fieldwork stage of the audit, the team identified that the potential issues pertaining to the Fleet and Industrial Supply Center Sigonella, Army, and NAVSEA contracts were notably different. Therefore, we separated the original project into four separate projects for the most effective and efficient method of meeting our audit objectives. This report addresses the audit objectives as they relate to NAVSEA; prior and follow-on audit reports address the issues regarding the other contracts. During the course of this audit our scope expanded from the original seven technical instructions selected in our sample. Specifically, we reviewed task orders 0002, 0006, 0007, 0008, 0010, 0011, 0012, 0013, and 0014 issued under IDIQ contract N00024-07-D-4002, from FY 2007 through FY 2009, valued at \$20.3 million. Our review included 238 technical instructions, valued at \$19.2 million, issued under these task orders from FY 2007 through FY 2009.

We met with officials from NAVSEA; the Navy Yard, Washington D.C.; and the MARMC, Norfolk Naval Base. We interviewed personnel at NAVSEA; the Navy Yard, Washington D.C.; the MARMC Detachment Bahrain; and the Commander, Naval Surface Forces. We conducted interviews with port engineers, diesel engine inspectors, ship commanding officers, and FMSNA personnel. We conducted a site visit at the Navy Yard, Washington D.C., from March 26 through April 7, 2009, and continued communication with NAVSEA through June 2010. We also conducted a site visit in Bahrain from May 25 through June 4, 2009.

We reviewed Federal and DOD criteria regarding cost-plus-a-percentage-of-cost contracts, obligations, quality assurance requirements, and pricing of spare parts transferred between affiliated companies. We specifically researched the FAR, the DFARS, the DOD FMR, United States Code, Deputy Secretary of Defense memoranda, and NAVSEA Instructions.

~~(FOUO)~~ We used two different sources to calculate the [REDACTED] in contracted for supplies and services with insufficient surveillance and acceptance in Finding C. Because the [REDACTED] only includes work performed in Bahrain, we took information from the task orders and from the COR's technical instruction checkbook. For task orders 0008 and 0012, we added the dollar values in the task orders for CLINs 0017AB and 0019AA and 0025AB and 0027AA, respectively, because these task orders obligated money only for Bahrain. The remaining four task orders, 0002, 0006, 0011, and 0013 obligated money for Bahrain and Japan through the same CLINs. In order to get the dollar value only for Bahrain, we had to rely on the dollar values in the COR's technical instruction checkbook for those CLINs because the task orders did not detail the breakout between Bahrain and Japan and the technical instruction checkbook was the only document we received that had the breakdown of the money.

Use of Computer-Processed Data

We used computer-processed data from the Federal Procurement Data System-Next Generation database to help choose our judgmental sample of contracts for the audit. We queried all contract actions related to ship maintenance performed in the U.S. Central Command countries since FY 2004. However, we did not rely on this data to support our findings. Therefore, we did not perform a reliability assessment of the computer-processed data.

Prior Coverage

No prior coverage has been conducted on ship maintenance contracts in Southwest Asia for NAVSEA during the last 5 years.

Related Coverage

The following DOD IG reports can be accessed online at <http://www.dodig.mil/Audit/reports/index.html>. The following DCAA reports are not available online.

DOD IG Reports on Cost-Plus-a-Percentage-of-Cost

DOD IG Report No. D-2009-108, "U.S. Air Forces Central War Reserve Materiel Contract," September 23, 2009

DOD IG Report No. D-2008-097, "Hurricane Relief Effort Costs on the Navy Construction Capabilities Contract," May 23, 2008

DOD IG Report No. D-2006-007, "Contracts Awarded to Assist the Global War on Terrorism by the U.S. Army Corps of Engineers," October 14, 2005

***Defense Contract Audit Agency Reports on Interdivisional
Transfers Pricing***

Defense Contract Audit Agency Report No. 01661-2004-D42000003, "Report on Postaward Audit," May 2, 2006

Defense Contract Audit Agency Report No. 01661-2005D24020001, "Report on Estimating System Deficiency Disclosed During Postaward Evaluation of Contract Number SP0760-03-D-9734," January 3, 2005

Appendix B. Concerns With Full-Service Trial Under Contract N00024-07-D-4002

During the audit, we were made aware of the full-service trial that NAVSEA issued and FMSNA executed onboard two MCM ships, the USS *Dextrous* and the USS *Gladiator*, under contract N00024-07-D-4002. Based on the results of the full-service trial, the Navy will decide if full-service contracts should be implemented onboard all MCM ships. However, the results of the full-service trial may not have been reliable as a basis for implementing full-service contracts onboard all MCM ships because there is no reasonable assurance that all data was captured or that the data captured was accurate. The Commander, Naval Surface Forces, was responsible for capturing all full-service trial data and evaluating the data to decide whether full-service trial contracts should be implemented onboard all MCM ships. We issued a memorandum in July 2010 to the Commander, Naval Surface Forces, regarding the full-service trial stating that the data obtained during the full-service trial may not have been reliable as the basis for implementing full-service contracts onboard all MCM ships.

Appendix C. Prior Pricing Issues With Other FMSNA Contracts

~~(FOUO)~~ FMSNA has been the subject of two DCAA reports. The first, DCAA Report No. 01661-2004D42000003, May 2, 2006, stated that DCAA examined FDGM, Inc.* cost or pricing data related to the pricing of contract SP0760-03-D-9734 [REDACTED]

~~(FOUO)~~ In another DCAA audit, Report No. 01661-2005D24020001, January 3, 2005, DCAA reported on a post-award evaluation of solicitation SP0760-02-R-3491 [REDACTED]

~~(FOUO)~~ In addition, a Defense Contract Management Agency price analyst informed a NAVSEA contracting specialist in a September 2005 e-mail that prior reviews by DCAA had [REDACTED]

[REDACTED]. The price analyst stated that the issue had not yet been resolved, but the Defense Contract Management Agency suspected it is likely that FMSNA had done the same [REDACTED] in the FDGM proposal for NAVSEA. The NAVSEA contracting specialist provided the contracting officer with the e-mail; therefore, the contracting officer was aware of the DCAA reports.

~~(FOUO)~~ The dispute the contracting officer is having with the contractor on contract N00024-07-D-4002 addresses the same issues that the DCAA reports contained: [REDACTED]

[REDACTED] FAR Subpart 9.103, "Policy," states that the contracting officer must make a determination as to whether the contractor is responsible before awarding a contract;

* FMSNA was formerly FDGM, Inc.

FAR 9.104-1, "General Standards," requires the contractor to have a satisfactory record of integrity and business ethics, and a satisfactory performance record to be considered responsible. A satisfactory performance record includes the contractor's history of reasonable and cooperative behavior and commitment to customer satisfaction, and record of integrity and business ethics. The contracting officer should have attempted to mitigate these problems prior to issuing the contract. However, contract N00024-07-D-4002 was awarded sole-source because FMSNA was the only contractor with the capability of performing the required work and providing the parts in accordance with Navy standards.

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